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California Cap-and-Trade Update Legislation

In recent years, California policymakers have explored additional legislation that would extend and further codify the state's cap-and-trade program. A legislative package containing AB 398 and AB 617, proposed on July 10, 2017, is the latest legislative effort to extend California's cap-and-trade program. Both bills passed with bipartisan support on Monday, July 17, and will be signed into law later this summer by California Governor Brown. This issue brief provides an overview of the legislation as well as key policy drivers that have shaped the conversation.

Background

In 2006, California passed AB 32, which established a limit on greenhouse gas (GHG) emissions—a return to 1990 levels by 2020. The California Air Resources Board (ARB) was tasked with developing a set of regulations to achieve required emissions reductions to meet this limit. This legislation stated that the ARB could use “market-based compliance mechanisms to comply with the regulations.”¹ Per this authority, the ARB established an economy-wide cap-and-trade program that took effect in 2013.

In recent years, California policymakers have explored additional legislation that would extend and further codify the state's cap-and-trade program to address a variety of policy and political considerations (see final section below for a discussion about some of these considerations). The California Legislature succeeded in 2016 in passing an update to AB 32's emissions targets: SB 32. Signed by Governor Jerry Brown in September, and the focus of ongoing rulemakings by ARB, SB 32 requires a 40 percent reduction in state GHG levels from 1990 levels by 2030.² On June 28, 2017, the California Supreme Court rejected an appeal of a lower court decision that had upheld the cap-and-trade program against a challenge from the California Chamber of Commerce and other parties.³ This effectively ended the litigation on the current cap-and-trade program while leaving the program intact. However, to date, legislation with more fundamental changes to address cap-and-trade market function, extension beyond 2020, and permanence has failed to pass.

¹ Cal. Health and Safety Code §38570.

² Instituted in Cal. Health and Safety Code §38566.

³ *California Chamber of Commerce v. State Air Resources Board*, Case Number S241948, (Cal. Jun. 28, 2017) denying petition for review. Available at http://appellatecases.courtinfo.ca.gov/search/case/disposition.cfm?dist=0&doc_id=2197989&doc_no=S241948.

Final Legislation

On July 10, the members of the California Assembly proposed new language in AB 398 and AB 617 to initiate the latest effort to extend the cap-and-trade program through legislation. AB 398 was sponsored by a group of 15 Democratic Assemblymembers and Senator De Leon;⁴ AB 617 was sponsored by 14 democratic Assemblymembers.⁵

The two bills were proposed as a package and passed on July 17, 2017. AB 398 directs the ARB to establish a cap-and-trade regulation through December 31, 2030 and makes important programmatic changes. It passed 54-21 in the California Assembly, with seven Republican Assemblymembers in support, and 27-12 in the Senate. AB 617 addresses air quality and criteria pollutants from stationary sources, including those that are covered under the cap-and-trade program. It passed 50-24 in the Assembly and 27-13 in the Senate. Since it could be interpreted as authorizing a tax or regulatory fee,⁶ AB 398 needed to be passed by a two-thirds majority. AB 617 only required a simple majority passage. Key components of each bill are summarized below.

AB 398: Cap-and-Trade Extension and Revision

AB 398 directs the ARB to establish a cap-and-trade regulation that is applicable from January 1, 2021 (the expiration date of the current explicit legislative authority for a cap-and-trade program) through December 31, 2030 and makes important programmatic changes. In addition to cap-and-trade provisions, AB 398 includes two unrelated provisions intended to gain the support of additional legislators and secure a two-thirds supermajority. These include an extension of a manufacturing tax credit and the repeal of a fee imposed on landowners used for fire prevention.

Price Ceiling

AB 398 requires that the ARB establish a price ceiling set at a level based on multiple factors, including the need to avoid adverse impacts on resident households, businesses, and the state's economy, the existing price containment mechanisms and price floor, the "full social cost" of GHG emissions, and the potential for environmental and economic leakage.⁷ Because this is a hard ceiling, it would likely require the release of additional allowances created by the state if prices reached ceiling levels. The legislation requires that any revenues generated from selling such allowances be used by the ARB to achieve real, permanent, quantifiable, verifiable and enforceable emissions reductions that are "in addition to any greenhouse gas emission reduction otherwise required by law or regulation."⁸

The legislation also requires that the ARB maintain certain intermediate ceiling provisions that are currently in place in the cap-and-trade program as the allowance price containment reserve (APCR). Per this legislation, the ARB must establish two price containment levels (as opposed to the APCR's current three) that are below the hard ceiling level, and at which covered compliance entities could purchase allowances. The number of allowances available for sale at these price levels will be equal to two thirds of the allowances remaining in the

⁴ Assemblymembers Eduardo Garcia, Senator De León, Cristina Garcia, Bloom, Chu, Dababneh, Gipson, Gonzalez Fletcher, Levine, Mullin, Muratsuchi, Nazarian, Quirk, Santiago, Weber, and Wood.

⁵ Assemblymembers Santiago, Bloom, Bocanegra, Chu, Friedman, Gipson, Gonzalez Fletcher, Holden, Jones-Sawyer, McCarty, Muratsuchi, Nazarian, Quirk, and Reyes.

⁶ Per California Proposition 13 (1976) and Proposition 26 (2010).

⁷ AB 398 SEC. 4, adding §38562 (c)(2)(A)(i) to the Cal. Health and Safety Code.

⁸ AB 398 SEC. 4, adding §38562(c)(2)(A)(ii)(II) to the Cal. Health and Safety Code.

APCR at the end of 2020. While it appears that no new allowances will be added to the APCR by pulling allowances from under the cap (as they currently are), any allowances that remain unsold at auction for more than 24 months will be added to this pool. Any allowances purchased from the APCR would be non-tradable, similar to allowances that can be purchased from the existing APCR.⁹

Offsets

The legislation also establishes new provisions relating to the use of offsets. Currently, California compliance entities may fulfill up to 8 percent of their compliance obligation with offsets. AB 398 lowers this limit to 4 percent between 2021 and 2025 and 6 percent from 2026 through 2030.¹⁰ At least half of offsets must provide “direct environmental benefits in the state,” which are defined as “the reduction or avoidance of emissions of any air pollutant in the state or the reduction or avoidance of any pollutant that could have an adverse impact on waters of the state.”¹¹ The legislation also requires that the ARB “develop approaches to increase offset projects in California” under guidance from the Compliance Offsets Protocol Task Force.¹² The Compliance Offsets Protocol Task Force must include representatives from a broad range of parties, including scientists, air regulators, carbon market experts, tribal representatives, environmental justice advocates, labor representatives, and various industry experts.¹³

Industry Allocation

To address concerns for certain industries, this legislation also requires the ARB to continue providing a free allocation of allowances to industrial customers. Under the current cap-and-trade regulation, industrial facilities receive allocations based on a variety of factors, including their “leakage risk” classification. Through 2017, all leakage risk classifications (high, medium, and low) receive nearly 100 percent of their output-based needs, adjusted down slightly each year to account for the declining overall emissions cap. However, starting in 2018, medium- and low-leakage risk industries (including, for example, dairy product manufacturing and petroleum refineries) would only receive 50 to 75 percent of their output-based needs.¹⁴ In contrast, the legislation requires that starting in 2021, the ARB provide free allocation to all industrial facilities at 2017 levels, i.e., nearly 100 percent of output-based needs. Allocations will still be adjusted down slightly each year to account for the decrease in the cap.¹⁵

Banking

Currently, the cap-and-trade program allows banking of allowances. It imposes “holding limits” on entities that vary by type of entity (i.e., compliance entity versus general market participant) that limit the number of allowances a party can hold in its trading account, which acts as a potential limit on banking (compliance entities have no limit on the number of allowances that they hold in their compliance accounts, which are non-tradable).

⁹ See AB 398 SEC. 4, adding §38562(c)(2)(B) to the Cal. Health and Safety Code.

¹⁰ See AB 398 SEC. 4, adding §38562(c)(2)(E)(i) to the Cal. Health and Safety Code.

¹¹ AB 398 SEC. 4, adding §38562(c)(2)(E)(ii) to the Cal. Health and Safety Code.

¹² AB 398 SEC. 4, adding §38562(c)(2)(F) to the Cal. Health and Safety Code.

¹³ See AB 398 SEC. 7, adding § 38591.1(a) to the Cal. Health and Safety Code.

¹⁴ See Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms §95870(e)

¹⁵ See AB 398 SEC. 4, adding §38562(c)(2)(G) to the Cal. Health and Safety Code.

AB 398 requires that the ARB “establish allowance banking rules that discourage speculation, avoid financial windfalls, and consider the impact on complying entities and volatility in the market.”¹⁶

ARB Review

The legislation also establishes new ARB reporting requirements. The first is a 2025 review, conducted by the ARB, of the provisions relating to the hard price cap, the offset usage limitation, and industrial allocation, specifically in regard to “trade exposure and the need to achieve [GHG] emission reduction targets.”¹⁷ A second is triggered if two consecutive auctions exceed the lower of the price containment prices, and requires ARB to work with the Emissions Market Advisory Committee to assess the potential for additional auctions to exceed the soft ceiling price.¹⁸ Finally, the ARB must make reports to the legislature on progress updating and implementing its Scoping Plan and revising the cap-and-trade program.¹⁹

Allowance Revenue Use

In AB 398, the legislature identifies required uses of revenue from allowance auctions. These uses must include, but need not be limited to: (1) air toxic and criteria air pollutants from stationary and mobile sources; (2) low-and zero-carbon transportation alternatives; (3) sustainable agricultural practices that promote the transitions to clean technology, water efficiency, and improved air quality; (4) healthy forests and urban greening; (5) short-lived climate pollutants; (6) climate adaptation and resiliency; and (7) climate and clean energy research.²⁰

AB 617: Criteria Pollutant Reporting and Control

AB 617 addresses air quality and criteria pollutants from stationary sources, including, specifically, those that are covered under the cap-and-trade program, and requires ARB to establish a process to monitor and reduce these emissions especially in disadvantaged and environmental justice communities.

Stationary Source Criteria Pollutant Reporting, Mitigation, and Clearinghouse

Under AB 617, the ARB must establish a uniform statewide system of annual reporting of emissions of criteria pollutants and toxic air contaminants for stationary sources, including any that are covered by the cap-and-trade program.

By January 1, 2019, each air quality management district that is a nonattainment area for one or more air pollutants must adopt an expedited schedule for the implementation of best available retrofit control technology (BARCT). Implementation of BARCT must be by the earliest feasible date and no later than December 31, 2023. This specifically includes any industrial source that, as of January 1, 2017, was subject to the cap-and-trade program.²¹ ARB must also establish and maintain a statewide clearinghouse that identifies the best available control technology (BACT) and BARCT for criteria air pollutants as well as related technologies for the control of toxic air contaminants.²²

¹⁶ AB 398 SEC. 4, adding §38562(c)(2)(H) to the Cal. Health and Safety Code.

¹⁷ AB 398 SEC. 4, adding §38562(c)(2)(I) to the Cal. Health and Safety Code.

¹⁸ See AB 398 SEC. 4, adding §38562(c)(2)(J) to the Cal. Health and Safety Code.

¹⁹ See AB 398 SEC. 4, adding §38562(c)(2)(K) to the Cal. Health and Safety Code.

²⁰ See AB 398 SEC. 6, adding § 38590.1(a) to the Cal. Health and Safety Code.

²¹ See AB 617 SEC. 2, adding §40920.6 to the Cal. Health and Safety Code.

²² See AB 617 SEC. 3, adding §40920.8 to the Cal. Health and Safety Code.

Environmental Justice Community Air Monitoring and Pollution Reductions Strategy

By October 1, 2018, the ARB must establish a monitoring plan regarding the effectiveness of advanced sensing monitoring technologies and existing community air monitoring systems for toxic air contaminants and criteria air pollutant. Based on this plan, the ARB must identify the highest priority locations in the state to deploy community air monitoring systems. By July 1, 2019, the ABR must deploy community air monitoring system in the selected location or locations, which could include requiring any stationary source that emits pollutants in, or that materially affect, a priority location to deploy a fence-line monitoring system or other appropriate real-time, on-site monitoring. Each January starting in 2020, the ARB must update the list of priority locations. Any data produced by the community air monitoring systems deployed pursuant to the legislation must be reported to the ARB and published on its website.²³

In addition, by October 1, 2018, the ARB must develop a statewide strategy to reduce emissions of toxic air contaminants and criteria air pollutants in communities affected by a high cumulative exposure burden. The state board shall update the strategy at least once every five years. The ARB then must select, based on this strategy, locations around the state for preparation of community emissions reduction programs. The air quality management districts encompassing these areas must adopt plans, approved by the ARB, to reduce emissions.²⁴

Key Policy and Political Considerations

Numerous policy considerations have shaped this legislation and previous efforts. The following highlights some of these key factors.

Long-term Program Viability

The ARB has authority to establish regulations to enforce legislatively-mandated emissions reductions, such as those imposed under AB 32 and SB 32. However, stakeholders have raised questions about whether a cap-and-trade program, as currently operated in California, actually functions as a tax. If so, the legislature would need to pass any cap-and-trade legislation with a two-thirds majority as required by Proposition 13 (1978).²⁵ AB 32 did not pass with such a supermajority, which has led to market uncertainty in past years as compliance entities and others are concerned with the program's long-term viability. The supermajority passage of AB 398 will likely significantly improve market certainty. Note that AB 617 did not require supermajority approval to take full effect.

Environmental Justice Concerns

The environmental justice community in California is concerned that a cap-and-trade program allows for the continuation of local emissions of GHG co-pollutants that harm disadvantaged communities. It is for this reason that AB 398 is paired with AB 617, and that passage of the two bills was linked.

Fuel Price Impacts

In April of this year, the California legislature passed a 12-cent increase in the base gasoline excise tax under SB1. Policymakers have expressed concern with additional fuel price increases from other legislation, such as an extension of the cap-and-trade program (which includes transportation fuels). This concern may lead to continued attention to include price containment mechanisms in any passed legislation including the hard price ceiling included in AB 398.

²³ See AB 617 SEC. 7, adding §42705.5 to the Cal. Health and Safety Code.

²⁴ See AB 617 SEC. 8, adding §44391.2 to the Cal. Health and Safety Code.

²⁵ An additional ballot measure, Proposition 26 (2010), also requires two-thirds passage of regulatory fees.

Environmental Integrity

Policymakers in California, from the ARB leadership to legislators to the Governor's office, remain focused on maintaining a program that provides real and quantifiable emissions reductions. A hard price ceiling, while providing a measure of market certainty, has the potential to result in emissions reductions above mandated levels, but may be necessary to balance concerns noted above.

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